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No. 89-393

In the Supreme Court of the United States

OCTOBER TERM, 1989

HARRY P. BEGIER, JR., ETC., PETITIONER

v.

UNITED STATES OF AMERICA

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE UNITED STATES

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QUESTION PRESENTED

Whether an employer's payments of its trust fund tax obligations to the government before it filed a petition in bankruptcy can be avoided as a preference under Section 547 of the Bankruptcy Code.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A2-A20) is reported at 878 F.2d. The opinion of the district court (Pet. App. A22-A26) is unreported. The opinion of the bankruptcy court (Pet. App. A27-A44) is reported at 83 Bankr. 324.

JURISDICTION

The judgment of the court of appeals was entered on June 30, 1989. A petition for rehearing was denied on July 28, 1989. Pet. App. A1. The petition for

a writ of certiorari was filed on September 11, 1989, and was granted on January 8, 1990. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

This case involves the payment of trust fund taxes made to the government by a corporate debtor during the 90-day period before the debtor filed a petition for relief in bankruptcy. The trust fund taxes are federal income and social security taxes withheld by the corporation from the wages of its employees, as well as transportation excise taxes collected by the corporation from its customers on behalf of the government. See 26 U.S.C. 3102, 3402, 4291. The Internal Revenue Code (26 U.S.C.) provides that those amounts are "held to be a special fund in trust for the United States" that must be paid over to the government. 26 U.S.C. 7501. In this case, the bankruptcy trustee is attempting to recover the debtor's payment of trust fund taxes under Section 547 of the Bankruptcy Code (11 U.S.C.). That provision allows a bankruptcy trustee to avoid as a preference certain payments made out of the debtor's property during the 90-day period before the debtor petitioned for relief in bankruptcy.

1. Petitioner is the trustee in bankruptcy of American International Airways, Inc., which was a commercial airline that provided passenger and air cargo service in the eastern and central United States. By the spring of 1984, American International was delinquent in remitting to the United States both social security and income taxes that it had withheld from the wages of its employees, as well as excise taxes that it had collected from its passengers. On March 1, 1984, the Internal Revenue Service (IRS) notified

the company of its delinquency and required it to file monthly, rather than quarterly, returns of its employment and excise taxes. The IRS also required American International to establish a separate bank account in which to deposit the withholding and excise taxes held in trust for the United States. Pet. App. A4, A29-A30.

Shortly after receiving that notice, American International opened a separate bank account into which it deposited some, but not all, of the excise and employment taxes held in trust for the government. On April 30, 1984, American International paid the IRS $695,000 from its separate trust account and $734,798 from its general operating account. The April payments were followed in June 1984 by two other payments—totalling $211,636—from American International's general account. By agreement with the IRS, the company allocated its payments to specific social security, income withholding, and excise taxes due and collected by American International between 1982 and April 1984. Pet. App. A4, A30-A31, A47-A48.

On July 19, 1984, American International filed a petition for relief under Chapter 11 of the Bankruptcy Code. For the following three months, it attempted to operate as a debtor-in-possession. After that attempt proved futile, the bankruptcy court appointed petitioner as the company's trustee and began liquidation proceedings. Petitioner then brought this adversary proceeding against the government under Section 547 of the Bankruptcy Code to recover as a preference the $1,641,434 in withholding and excise taxes that the company had paid to the IRS in April and June 1984. Pet. App. A4, A27-A28.[1]

[1] The IRS filed a proof of claim in the Chapter 11 case that sought, among other things, the unpaid portion of withholding

2. The bankruptcy court permitted the trustee to recover from the government a portion of the funds in question. Pet. App. A27-A44. It held that the $695,000 payment made by the company from its segregated trust account was a non-avoidable transfer of funds held in trust for the government under Section 7501 of the Internal Revenue Code; therefore, the bankruptcy court did not allow the trustee to recover those funds. *Id.* at A32. The court ruled, however, that American International's payments of trust fund taxes from the company's general account did not constitute a transfer of funds held in trust for the government. It therefore allowed the trustee to recover most of the payments made from that general account. *Id.* at A32-A44.[2] The court reasoned that trust fund taxes are exempt from the provisions regarding preferential transfers "only where a tax trust fund is actually established by the debtor and the taxing authority is able to trace funds segregated by the debtor in a trust account established for the purpose of paying the taxes in question." *Id.* at A35.

The government appealed to the district court, which affirmed in a decision issued from the bench. Pet. App. A22-A26. Although finding it to be "a very

taxes for the first quarter of 1984. This preference action involves withholding taxes for the same period. Thus, the government's sovereign immunity with respect to the trustee's action is waived under 11 U.S.C. 106(a). See S. Rep. No. 989, 95th Cong., 2d Sess. 20-30 (1978).

[2] The court held that $246,024 of the amount paid out of the general account was not a voidable preference because it was paid for taxes due less than 45 days before the payment and therefore constituted a non-avoidable payment in the "ordinary course of business." Pet. App. A43-A44. See 11 U.S.C. 547(c)(2) (1982).

close case" (*id.* at A26), the district court concluded that the bankruptcy court correctly held that the payments from the general account should not be treated as having been made out of a trust fund. The district court concluded that the IRS must show at least "some evidence beyond that of merely [the debtor's] having made the payment" in order to establish that payments from commingled corporate funds were actually payments of funds held in trust for the United States. *Id.* at A25.

3. The court of appeals reversed. Pet. App. A2-A20. After reviewing Section 547 of the Bankruptcy Code, the court concluded that Congress regarded "the act of payment of withholding taxes [as] identify[ing] those taxes as funds held in trust" for the government. Pet. App. A16. The court drew a distinction between payments made before bankruptcy (as in this case) and efforts by the IRS to recover funds from a bankruptcy estate. The court noted that, in the latter context, Congress sought to relax the strict tracing of trust fund taxes required in the aftermath of this Court's decision in *United States* v. *Randall*, 401 U.S. 513 (1971). In *Randall*, the Court had refused to allow the government to recover commingled trust fund taxes from a bankruptcy estate. Under the new Bankruptcy Code, the court of appeals held, Congress rejected the *Randall* approach and established the rule that the IRS can use "reasonable assumptions" to trace funds in the bankruptcy estate to withheld taxes belonging to the government. Pet. App. A10-A11. But where the debtor makes payments identified as trust fund taxes before it files a bankruptcy petition, the court held, the government is not required to trace further such trust fund payments back to the actual taxes withheld or collected

by the employer. The court of appeals found that the legislative history of Section 547 demonstrates Congress's intent that monies actually paid by the debtor to meet its trust fund obligations should be regarded, in fact, as the payment of trust taxes. *Id.* at A13-A19. Accordingly, the court concluded that "the debtor's pre-petition payments on account of its tax withholding obligations are held to be a special fund in trust for the IRS for the government under I.R.C. § 7501 and are not preferential transfers of the debtor's property under 11 U.S.C. § 547(b)." *Id.* at A20.

The court of appeals acknowledged that its holding conflicts with *Drabkin* v. *District of Columbia*, 824 F.2d 1102 (D.C. Cir. 1987). The court stated that it found "the *Drabkin* dissent convincing" (Pet. App. A13) because the majority in *Drabkin* had misinterpreted the legislative history of Section 547 and had failed to distinguish between a debtor's pre-petition payment of withheld taxes and a post-petition action by the IRS to recover withheld taxes in possession of the bankruptcy estate. See Pet. App. A18-A19. Judge Hutchinson dissented for the reasons set forth by the majority in *Drabkin*. *Id.* at A20.

SUMMARY OF ARGUMENT

1. Section 547 of the Bankruptcy Code allows a bankruptcy trustee to recover certain preferential transfers of the debtor's property that were made before the debtor filed its petition in bankruptcy. Such a transfer can qualify as an avoidable preference only if the property would have been a part of the bankruptcy estate for the benefit of the creditors. And it is clear under Section 541 of the Bankruptcy Code that property held in trust is not available to satisfy the claims on the bankruptcy estate. Hence,

the preference provisions in Section 547 do not reach pre-petition payments of funds held in trust.

2. In this case, American International (the debtor in bankruptcy) withheld federal social security and income taxes from its employees' wages. American International also collected federal excise taxes from the users of its transportation services. Section 7501 of the Internal Revenue Code provides that "the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States." Accordingly, American International's four payments of trust fund taxes to the IRS were payments of funds held in "trust for the United States" and, therefore, may not be reached as preferences under Section 547 of the Bankruptcy Code.

Contrary to petitioner's contention, a trust relationship is not created under Section 7501 only when the collector or withholder of federal taxes places those funds in a separate account with a "trust" label. Section 7501 provides in general terms that the "amount" of funds collected or withheld "shall be held to be a special fund in trust." Thus, as every appellate court that has considered the issue has recognized, the statutory trust relationship is created at the moment the private party withholds or collects the federal taxes.

3. In *United States* v. *Randall*, 401 U.S. 513 (1971), this Court refused to allow the government to recover trust fund taxes from a bankruptcy estate without following the old Bankruptcy Act's rules of priority. The Congress that adopted the Bankruptcy Code in 1978 disapproved *Randall* in two respects. First, Congress made it clear that trust fund taxes do not become a part of a bankruptcy estate for the benefit of creditors. Second, Congress relieved the government from any duty to trace such trust fund

taxes into the bankruptcy estate with precision. Instead, Congress has authorized the government to use reasonable assumptions to identify trust fund taxes.

This case does not involve an attempt by the government to identify trust assets in the bankruptcy estate. At the very least, however, the pre-petition payments at issue cannot qualify as preferences under Section 547 if the funds would not have become part of the estate if the payments had not been made. And the government has plainly used "reasonable assumptions" in concluding that the payments at issue were payments of funds held in trust for the United States. Those payments were: (1) made from American International's general account, (2) made to satisfy American International's obligation to turn over trust fund taxes to the IRS, and (3) identified by American International itself as trust fund taxes. It is surely reasonable for the trust beneficiary to assume that payments identified by the trustee as trust payments are, in fact, trust payments.

Moreover, Congress specifically endorsed the reasonableness of such an approach to pre-petition payments of trust fund taxes. In a passage that fully comports with the text of all pertinent stautory provisions, the relevant House Committee Report on Section 547 stated that a payment of withholding taxes "will not be a preference because the beneficiary of the trust, the taxing authority, is in a separate class with respect to those taxes, if they have been properly held for payment, as they will have been if the debtor is able to make the payments." H.R. Rep. No. 595, 95th Cong., 1st Sess. 373 (1977). Here, American International was able to make four pre-petition payments of the trust fund taxes that it had collected or withheld. Hence, as the House Report recognized,

those payments are not preferences that may be recovered by the bankruptcy estate.

ARGUMENT

AMERICAN INTERNATIONAL'S PAYMENTS OF ITS WITHHOLDING AND EXCISE TAX LIABILITIES WERE PAYMENTS OF FUNDS HELD IN TRUST FOR THE UNITED STATES AND, THEREFORE, CANNOT BE RECOVERED FROM THE GOVERNMENT AS PREFERENCES UNDER 11 U.S.C. 547

This is an action against the United States to recover payments of the debtor's trust fund tax liabilities to the IRS that were made before the debtor filed a petition under the Bankruptcy Code. The Third Circuit correctly held that those payments were not preferences under 11 U.S.C. 547 because they were payments of funds held in trust for the United States.

A. Payments Of Funds Held In Trust Are Not Avoidable Preferential Transfers Under 11 U.S.C. 547

1. Section 547 of the Bankruptcy Code allows a bankruptcy trustee to recover certain preferential transfers of "property of the debtor" made before the debtor filed its petition in bankruptcy.[3] The Bankruptcy Code does not define the phrase "property of the debtor."[4] But the fundamental purpose of Sec-

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[3] Section 547 allows a trustee to avoid transfers that were made on or within 90 days before the debtor filed its petition for relief under the Bankruptcy Code. Such an avoidable transfer is called a "preference."

[4] Section 462(b) of the Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 378 (1984 Act) substituted for the phrase "property of the debtor" in Section 547(b) the phrase "an interest of the debtor in property." Although the legislative commentary on the 1984 Act does not explain the amendment, it is described by the

tion 547 is to preserve the "property of the estate" (11 U.S.C. 541(a))) for the benefit of creditors. As a starting point, therefore, the courts have consistently looked to the definition of estate property in Section 541 as guidance for the type of property that may be recovered as a preference under Section 547. See *Drabkin* v. *District of Columbia*, 824 F.2d 1102, 1104 & n.8 (D.C. Cir. 1987); *Elliott* v. *Frontier Properties/LP (In re Lewis W. Shurtleff, Inc.)*, 778 F.2d 1416, 1419 (9th Cir. 1985); *Perry* v. *General Motors Acceptance Corp. (In re Perry)*, 48 Bankr. 591, 599 n.14 (Bankr. M.D. Tenn. 1985). If transferred property is not the type of property that would have become property of the estate for the benefit of creditors, it may never be recovered under Section 547(b). See *Drabkin* v. *District of Columbia*, 824 F.2d at 1104-1105; *Clark* v. *Mutual Lumber Co.*, 206 F.2d 643, 646-647 (5th Cir. 1953). See also 4 L. King, *Collier on Bankruptcy* ¶ 547.03[2] (15th ed. 1989) ("A transfer is preferential only if the property or the interest in property transferred belongs to the debtor.").

2. A debtor's mere possession of certain property does not mean that such property is available in the bankruptcy estate for the benefit of creditors. For example, no one doubts that creditors of an insolvent dry cleaner may not satisfy their claims by recovering as preferences the clothes that were picked up by patrons soon before the cleaner filed its petition in

Senate Report introducing a predecessor bill as a "clarifying change." S. Rep. No. 65, 98th Cong., 1st Sess. 81 (1983), commenting on S. 455, 98th Cong., 1st Sess. § 359(b) (1983). The amendment is effective as to cases filed 90 days after the enactment of the 1984 Act (§ 553(a), 98 Stat. 392), and is therefore not applicable to this case, which was filed on July 19, 1984.

bankruptcy. Nor could creditors of a parking garage recover for the bankruptcy estate the cars that were returned to their owners in the days before the garage filed a bankruptcy petition. See *Collier on Bankruptcy, supra*, ¶ 547.03; Jackson, *Statutory Liens and Constructive Trusts in Bankruptcy; Undoing the Confusion*, 61 Amer. Bankr. L.J. 287, 290 (1987).

It is equally well settled that, by virtue of Section 541(d) of the Bankruptcy Code, property held by the debtor in trust for another does not become a part of the bankruptcy estate for the benefit of creditors. As the Court noted in *United States* v. *Whiting Pools, Inc.*, 462 U.S. 198, 204 n.8 (1983), under Section 541 of the Bankruptcy Code, "Congress intended to exclude from the estate property of others in which the debtor had some minor interest such as a lien or bare legal title." [5] See also S. Rep. No. 1106, 95th Cong., 2d Sess. 33 (1978) ("amounts held by the debtor as trustee for another are not property of the estate"); 124 Cong. Rec. 34,016-34,017 (1978) (statement of Sen. DeConcini) ("property of the estate does not include the beneficial interest in property held by the debtor as trustee"); *id.* at 32,399 (statement of Rep. Edwards).[6] Accordingly, all courts have agreed that

[5] Section 541(d) of the Bankruptcy Code would allow recovery of a debtor's legal title to funds held in trust. But petitioner does not seek such legal title; he wants the money at issue to be paid by the government to the estate so it will be available to satisfy the claims on the estate.

[6] Although there were substantial differences between the House and Senate versions of the proposed Bankruptcy Code, time constraints prevented the preparation of a conference committee report reconciling those differences. Instead, the principal congressional sponsors of the statute, Representative Don Edwards and Senator Dennis DeConcini, made oral reports to Congress on the results of the closed-door confer-

a pre-petition transfer of funds held in trust may not be recovered by the estate as a preference. See Pet. App. A14-A15; *Drabkin* v. *District of Columbia*, 824 F.2d at 1107. That rule applies with equal force where, instead of a private instrument, it is a "statutory provision[] * * * that creates a trust fund." 124 Cong. Rec. 32,399 (1978) (statement of Rep. Edwards).

The precise question in this case, therefore, is whether American International's 1984 payments to the IRS were payments of funds held in trust for the government. A natural reading of the relevant provisions of the Internal Revenue and Bankruptcy Codes, as well as legislative history pertaining to this precise matter, lead to the same conclusion—the payments at issue were properly treated as non-avoidable payments of trust fund taxes.

B. The "Amount Of Tax" That American International Withheld And Collected Was Held In Trust For The Government

1. Beginning in the 1930s, the federal government has increasingly used private businesses and employers to collect federal taxes. See Note, *The Private Tax Collector—A New Fiduciary*, 60 Harv. L. Rev. 786 (1947). This case involves such a collection method for three federal taxes. Sections 3102 and 3402 of the Internal Revenue Code require that an employer withhold federal income taxes and Federal

ences. See 124 Cong. Rec. 32,350, 32,391, 32,392 (1978) (statement of Rep. Edwards); *id.* at 33,989, 33,990 (statement of Sen. DeConcini). See generally, Klee, *Legislative History of the New Bankruptcy Code,* 28 De Paul L. Rev. 941 (1979). This Court has viewed those floor statements as persuasive evidence of Congress's intent. See, *e.g., CFTC* v. *Weintraub,* 471 U.S. 343, 351 (1985).

Insurance Contribution Act (FICA) taxes from its employees' wages. The withheld tax is "owed" exclusively by the employee; thus the employee, and not the employer, is entiteld to a refund or credit if the employer withholds an excessive amount. See Treas. Reg. § 31.6402(a)-2(a)(2) and (b) (26 C.F.R.). A similar scheme governs the payment of excise taxes for transportation services, which are collected by the party providing such services. See 26 U.S.C. 4291.

A withholding of taxes under Sections 3102 and 3402 occurs whether or not the employer physically deposits withheld income and FICA taxes in a separate "withholding" account when it pays its employees' wages. The Senate Finance Committee has given a simple example. It stated that, if an employer owes $100 in wages, and pays the employee $80, then "there has been $20 withheld." S. Rep. 1106, 95th Cong., 2d Sess. 33 (1978).[7] Employers are required to make periodic deposits of withholding taxes with designated depositaries. See Treas. Reg. § 31.6302 (c)-1 (26 C.F.R.). Collectors of excise taxes are required to make similar periodic deposits. See Treas. Reg. § 49.6302(c)-1 (26 C.F.R.). The time for making such deposits depends upon various factors—*e.g.*, the size of the withholding and the timing of the employers' pay period. In general, however, deposits into the accounts of the United States Treasury are not made at the same time the taxes are withheld or collected. See *Slodov* v. *United States*, 436 U.S. 238, 243 (1978).

If the collector of excise, FICA, or withholding taxes fails to turn the money over to the government,

[7] Likewise, a transportation entity collects $20 in transportation excise taxes when a passenger pays it $100 for a ticket that costs $80.

the government has no recourse against the taxpayer. Excise taxes cannot be collected twice, and withheld taxes are "credited to the employee regardless of whether they are paid by the employer." *Slodov* v. *United States*, 436 U.S. at 243; see, *e.g.*, Treas. Reg. § 1.31-1(a) (26 C.F.R.). The government's receipt of taxes collected or withheld by employers (and others) is thus at risk by virtue of the time gap between collection and deposit into a designated agent of the Treasury. As the Court observed in *United States* v. *Sotelo*, 436 U.S. 268, 277 n.10 (1978):

> [i]t is a common phenomenon of business failure that even an "honest" businessman, in attempting to salvage a business which appears headed for insolvency, will frequently "borrow" money of other people without their consent if he can get his hands on it. The one fund which he is almost always able to lay his hands on is the taxes he has withheld and is currently withholding from his employees for the Government.

See also *Slodov* v. *United States*, 436 U.S. at 243.

Congress addressed that concern in 1934 by creating a statutory trust relationship between the collector of federal excise taxes and the government. See § 607 of the Revenue Act of 1934, ch. 277, 48 Stat. 768. In 1939, Congress extended the statutory trust provision to cover all withheld or collected taxes. See 53 Stat. 448. The statutory trust provision is currently codified as Section 7501 of the Internal Revenue Code. Section 7501 provides:

> Whenever any person is required to collect or withhold any internal revenue tax from any other person and to pay over such tax to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States.

The Senate Committee that recommended enactment of the predecessor to Section 7501 explained its purpose and effect:

> Existing law provides with respect to a number of taxes that the amount of the tax shall be collected or withheld from the person primarily liable by another person, who is required to return and pay to the Government the amount of the taxes so collected or withheld by him. This is true, for example, in the case of the taxes on admissions, checks, and telephone and telegraph services. Under existing law the liability of the person collecting and withholding the taxes to pay over the amount is merely a debt, and he cannot be treated as a trustee or proceeded against by distraint. Section 606 of the bill as reported impresses the amount of taxes withheld or collected with a trust and makes applicable for the enforcement of the Government's claim the administrative provisions for assessment and collection of taxes.

S. Rep. No. 558, 73d Cong., 2d Sess. 53 (1934); see also H.R. Conf. Rep. No. 1385, 73d Cong., 2d Sess. 32 (1934).

Thus, Section 7501 establishes beyond doubt that the amounts of taxes withheld by a third party are not merely debts of the withholder; such amounts "shall be held to be a special fund in trust for the United States." As the court succinctly observed in *Kalb* v. *United States*, 505 F.2d 506, 509 (2d Cir. 1974), cert. denied, 421 U.S. 979 (1975), "[i]n paying taxes over to the government the employer merely

surrenders that which does not belong to him." See also *Newsome* v. *United States*, 431 F.2d 742, 745-746 (5th Cir. 1970). If the employer fails to turn over funds held in trust, then the government may "treat" the employer "as a trustee" and "proceed[] against [the funds] by distraint." S. Rep. No. 558, *supra*, at 53. See also *In re Allied Elec. Products, Inc.*, 194 F. Supp. 26, 30-31 (D.N.J. 1961).

In this case, American International made four relevant payments to the IRS of collected and withheld trust taxes. Pet. App. A4. Those funds, by operation of Section 7501, were "a special fund in trust for the United States." And American International agreed that its four payments were made to satisfy its obligation to turn over trust fund taxes to the government (as opposed to American International's own tax debts owed to the government). Accordingly, American International's payments of trust funds to the proper beneficiary—the United States—falls within the well-recognized rule that pre-petition payments of trust funds may not be recovered by the bankruptcy estate as preferential transfers under 11 U.S.C. 547.

2. We understand petitioner to agree with much of our analysis to this point. Petitioner does not now claim that American International's payment of $695,000 from the separate "trust" account was a preferential transfer. That is so, in petitioner's view, because the $695,000 came from a segregated account, not the company's general account. In other words, petitioner's main argument (Br. 19-21) is that a trust for the benefit of the United States is created under Section 7501 only if the withheld or collected taxes are placed in a separate "trust" account. Petitioner's formalistic position, however, finds no support

in the language of the statute, the IRS regulations, or the relevant case law.[8]

Section 7501 is written in general terms, with no suggestion that a trust is created only if the withheld or collected taxes are placed in a separate account with a "trust" label before they are turned over to the government. It provides that "the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States." The words "shall be held to be" mean that a trust in the "amount" of taxes withheld or collected is created by operation of law; a trust is not dependent upon or created by an employer's deposit of funds into a bank account labeled "trust account."[9] Thus, as the Court stated in *Slodov* v. *United States*, 436 U.S. at 243, "[t]here is no general requirement [in Section 7501] that the withheld sums be segregated from the employer's general funds * * * or that they be deposited in a separate bank

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[8] Petitioner also errs in describing this case as one involving a question of priorities. Petitioner points to the "ascending priority for costs and expenses of bankruptcy administration" (Br. 24), and concludes that "the Internal Revenue Service should be treated no differently than any other creditor." Br. 23. This case, however, does not involve questions of priorities in a pool of funds but, rather, whether that pool may be expanded by trust fund taxes previously paid to the IRS. Although Congress has made clear that costs and expenses of administration are to have priority in bankruptcy, 11 U.S.C. 507, it has never stated any intention to force the IRS to turn over trust fund taxes to underwrite those costs and expenses.

[9] This is also implied by Section 7501's statement that a trust is created in "the amount of tax so collected or withheld." The "res" of the trust is thus an abstract "amount"—not a tangible collection of money in a designated trust account.

account until required to be paid to the Treasury." [10] See also Treas. Reg. § 31.6302(c)-1 (26 C.F.R.).[11] Consequently, if an employer fails to pay over withheld taxes, the IRS may levy on the employer's bank accounts, see 26 U.S.C. 6331-6344, and it is no defense for the employer to say that its account does not contain the same "funds" that were withheld as taxes. See generally *In re Gotham Provisions Co.*, 669 F.2d 1000, 1011 (5th Cir. 1982).

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[10] *Slodov* involved the question whether a corporate officer was subject to the "one hundred percent penalty" of 26 U.S.C. 6672 for his failure to use after-acquired funds to pay withholding taxes that had become delinquent before he gained control of the corporation. Reasoning that Congress had not intended Section 6672 to impose liability without fault, the Court held that the trust created by Section 7501 attached only to funds that had some nexus to the taxes withheld. 436 U.S. at 253-256. *Slodov* did not address the question of *how* that nexus could be established in a case involving 26 U.S.C. 7501 and Section 547 of the new Bankruptcy Code.

[11] If an employer fails to carry out its responsibilities to collect, account for, and pay over the trust fund taxes in a timely fashion, the IRS can require the employer to establish a separate tax account, as it did here. See 26 U.S.C. 7512. Section 7501, however, does not make the existence of the trust dependent upon the creation of a separate account. Petitioner errs in asserting (Br. 19-20 n.15) that Section 31.6302(c)-1 (26 C.F.R.) requires segregation of trust funds. Both that Section and Section 49.6302(c)-1 concern the *payment* of trust funds to designated financial agents of the government, not the establishment of a trust. It is illogical to suppose, as does petitioner (Br. 10), that "[t]he failure to pay these monies into an established tax depository bars the creation of the trust mandated by §7501." Once trust fund taxes are so deposited, they are under the control of the government and there is no longer any need for the trust provision contained in Section 7501.

Petitioner's claim that Congress implicitly intended to require a segregated trust account is also inconsistent with the purpose of Section 7501. As we explained above, Congress enacted Section 7501 to give the government a powerful new tool in receiving taxes collected by third parties. But there was no hint that the new tool—*i.e.*, the statutory trust—was dependent on the third party's opening and making deposits in an actual "trust fund" account in a financial institution.

An employer withholds taxes when it pays its employees less than they are due in wages. See p. 13, *supra*. There is no check or cash delivered from the employee to the employer. Hence, the effect of the withholding on the employer's general bank account is simply to reduce what would otherwise be paid out in wages. There is no tangible "res" that must be deposited somewhere; rather, the employer must only make an accounting notation in its books. Thus, "it is hard to conclude that Congress, having determined that, as additional protection for the Government, [withheld or collected] funds should be held in trust, simultaneously devitalized that provision by hinging its effectiveness upon the employers' method of" keeping accounts. Heffron, *Fraud in Withholding*, 18 N.Y.U. Inst. on Fed. Tax'n 1073, 1076 (1960). Accordingly, Congress and the courts have consistently ruled that Section 7501 imposes a trust on the amounts of withheld and collected taxes even if those amounts are part of a general business account including funds from several sources. See Pet. App. A10-A11; see also 124 Cong. Rec. 32,417 (1978) (statement of Rep. Edwards); *id.* at 34,017 (statement of Sen. DeConcini).[12]

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[12] Even the District of Columbia Circuit in *Drabkin* v. *District of Columbia*, *supra*, recognized that deposits into a sep-

C. The Payments In This Case, Which Were Identified By American International As Trust Fund Taxes, Were Properly Treated As Trust Payments Under Section 547 Of The Bankruptcy Code

1. Although Section 7501 does not require a separate trust fund account, we do not suggest that there need be no nexus between the amounts of withheld or collected taxes and the statutory trust fund. Cf. *Slodov* v. *United States*, 436 U.S. at 256. Over the years, the courts have used a considerable array of rules to establish such a connection between the original source of a trust fund and property that is later used to satisfy the trustee's obligations to the beneficiary. Such rules—often called "tracing" rules—have varied widely depending on the context and reasons for the trust. See G. Bogert, *The Law of Trusts and Trustees* §§ 921-930 (2d ed. 1982).

One tracing rule employed by courts in the setting of traditional trusts created by private instruments is the so-called "swollen asset" doctrine. See G. Bogert, *The Law Of Trusts and Trustees, supra*, § 922. That rule essentially allows a trust beneficiary to trace trust funds into the trustee's general accounts. The rule is premised on the notion that the trustee's unauthorized use of trust funds relieved it of using non-trust asests and thus "swelled" the trustee's other accounts. See, *e.g.*, *Schumacher* v. *Harriett*, 52 F.2d 817, 819 (4th Cir. 1931) (collecting cases); *Edwards* v. *Lewis*, 98 Fla. 956, 966-969, 124 So. 746, 749-750 (1929); *Eastman* v. *Farmers' State Bank*, 175 Minn. 336, 339-340, 221 N.W. 236, 237 (1928). The Congress that adopted the Bankruptcy Code endorsed that tracing rule in a context

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arate account were not needed to create a trust relationship under Section 7501. See 824 F.2d at 1116.

different from this case—where the debtor did *not* make its payment of trust fund taxes *before* it filed a bankruptcy petition and the government seeks to recover such funds from the bankruptcy estate. To understand how Congress reached that conclusion, however, it is necessary first to return to the case of *United States* v. *Randall*, 401 U.S. 513 (1971).

In *Randall*, the district court had ordered the debtor to pay withheld taxes into a special account, but the debtor had failed to comply. When the debtor was later adjudged bankrupt, the United States sought to recover the amount of the withheld taxes ahead of the payment of costs and expenses of administration of the bankruptcy proceedings. This Court, however, held that Section 64(a)(1) of the old Bankruptcy Act, which gave first priority to the costs and expenses of administering a bankruptcy estate, constituted an "overriding statement of federal policy on this question." 401 U.S. at 515. The Court therefore concluded that enforcement of the trust created by Section 7501 "would run counter to the grain of the Bankruptcy Act." *Id.* at 517.

In applying *Randall* in cases arising under the Bankruptcy Act, the lower courts placed heavy or insurmountable burdens upon the IRS when it sought to recover trust fund taxes from a bankruptcy estate. Some courts interpreted *Randall* to mean that, in order to establish that funds held by the bankruptcy estate were trust funds, the IRS was required to trace rigorously such funds to monies actually withheld for the payment of the taxes at issue. See, *e.g.*, *In re Rohar Associates, Inc.*, 375 F. Supp. 637 (S.D.N.Y. 1974). The Ninth Circuit refused to recognize trusts even when such tracing was possible. See *England* v. *United States (In re Shakesteers Coffee Shops)*, 546 F.2d 821 (1976); *Rothman* v.

United States (In re Tamasha Town and Country Club), 483 F.2d 1377 (1973).

Congress was aware of that situation in 1978 when it adopted the new Bankruptcy Code. See 124 Cong. Rec. 32,417 (1978) (statement of Rep. Edwards); *id.* at 34,017 (statement of Sen. DeConcini); S. Rep. No. 1106, *supra*, at 33 & n.25. And Congress made clear that it was disapproving both of those readings of *Randall*. Congress drafted the new Bankruptcy Code so that: (1) trust fund taxes do not become a part of a bankruptcy estate for the benefit of creditors, and (2) the IRS is not required to trace trust fund taxes with precision.

a. As we explained above, Section 541(d) of the Bankruptcy Code excludes from the definition of "estate property" all property in which the debtor holds "only legal title and not an equitable interest." In other words, Congress rejected the notion that, by commencing bankruptcy proceedings, the debtor could enlarge his rights in property by acquiring beneficial use of funds previously held only in trust. See H.R. Rep. No. 595, *supra*, at 367-368; S. Rep. No. 989, *supra*, at 82. See also 124 Cong. Rec. 32,399 (1978) (statement of Rep. Edwards); *United States* v. *Whiting Pools, Inc.*, 462 U.S. at 204 n.8.

The Senate passed a version of Section 541 that explicitly excluded from the estate all taxes witheld or collected from others before commencement of the case. See S. 2266, 95th Cong., 2d Sess. (1978). The Senate Report emphasized that this included "taxes withheld or collected by the debtor from others," and that "[t]his rule supersede[d] cases holding that withheld amounts are property of the estate." S. Rep. No. 1106, *supra*, at 33 & n.25. Congress deleted that provision in the Senate Bill only because Congress believed it was "unnecessary since property of the

estate does not include the beneficial interest in property held by the debtor as a trustee. Under the Internal Revenue Code of 1954 (section 7501), the amounts of withheld taxes are to be a special fund in trust for the United States." 124 Cong. Rec. 34,016-34,017 (1978) (statement of Sen. DeConcini); see also *id.* at 33,999 (Section 541 will not "affect various statutory provisions * * * that creates [*sic*] a trust fund for the benefit of creditors") (statement of Sen. DeConcini); *id.* at 32,399 (statement of Rep. Edwards). See *Drabkin* v. *District of Columbia*, 824 F. 2d at 1114; *Selby* v. *Ford Motor Co.*, 590 F.2d 642, 648 n.18 (6th Cir. 1979); *Schifter* v. *First Fidelity Financial Services, Inc.* (*In re First Fidelity Financial Services, Inc.*), 36 Bankr. 508, 513 (Bankr. S.D. Fla. 1983); *Olsen* v. *Deutscher (In re Nashville White Trucks, Inc.)*, 22 Bankr. 578, 587 n.12 (Bankr. M.D. Tenn. 1982).

b. Congress also disapproved the strict tracing requirements that some courts had adopted in *Randall*'s wake. The joint floor statements addressed the situation where the government attempts, after a petition for bankruptcy relief has been filed, to recover trust fund taxes that have been commingled with other funds:

> Where it is not possible for the Internal Revenue Service to demonstrate that the amounts of taxes withheld are still in the possession of the debtor at the commencement of the case, present law generally includes amounts of withheld taxes as property of the estate. *See, e.g., United States* v. *Randall*, 401 U.S. 513 (1973) and *In re Tamash Town and Country Club*, 483 F. 2d 1377 (9th Cir. 1973). Nonetheless, a serious problem exists where "trust fund taxes" withheld from others are held to be property of the estate where the withheld amounts are commingled with other

> assets of the debtor. The courts should permit the use of reasonable assumptions under which the Internal Revenue Service, and other tax authorities, can demonstrate that amounts of withheld taxes are still in the possession of the debtor at the commencement of the case. For example, where the debtor had commingled that amount of withheld taxes in his general checking account, it might be reasonable to assume that any remaining amounts in that account on the commencement of the case are the withheld taxes.

124 Cong. Rec. 32,417 (1978) (statement of Rep. Edwards); *id.* at 34,017 (statement of Sen. DeConcini); see also S. Rep. No. 1106, *supra*, at 33.

Accordingly, the courts of appeals have agreed that Congress, in enacting the Bankruptcy Code, intended to permit the government to use "reasonable assumptions" to identify and recover trust fund taxes that are included in the commingled funds of a bankruptcy estate. See Pet. App. A11, A19; *Drabkin* v. *District of Columbia*, 824 F.2d at 1115. One such assumption is essentially the "swollen asset" doctrine (see p. 20, *supra*)—*i.e.*, in the absence of contrary evidence, "any remaining amounts" in the debtor's general "account on the commencement of the case are the withheld taxes." 124 Cong. Rec. 32,417 (1978) (statement of Rep. Edwards); *id.* at 34,017 (statement of Sen. DeConcini).

To be sure, this case does not involve the government's attempt to identify trust assets in the bankruptcy estate. At the very least, however, the payments at issue in this case cannot be reached as preferences under Section 547 if the funds would not have become part of the estate if the payments had not been made. See pp. 10-11, *supra*. And there can be little doubt that the government has used "reasonable assumptions" in concluding that the payments at issue in this case were payments of trust fund taxes. The payments were made from American International's general operating account. The payments were made to satisfy its obligation to turn trust fund taxes over to the IRS. And, significantly, American International itself identified the payments as trust fund taxes.[13] If this case involved a traditional private trust that began with an identifiable and tangible res, it would be reasonable to assume that the funds remaining in American International's general account were linked to trust property. See p. 20, *supra*. Thus it is surely reasonable for the IRS to assume that payments identified as trust fund taxes—which were originally collected by notations in American International's books—are exactly what they purport to be: payments of trust fund taxes that were held by American International for the benefit of the United States.

2. Indeed, the Court does not have to judge for itself whether the government reasonably may treat pre-petition payments due and identified as trust fund taxes as such—trust payments. Congress, in adopting Section 547 of the Bankruptcy Code, specifically endorsed the reasonableness of such an approach to payments made to the government before a debtor files a bankruptcy petition.

Section 547 of the Bankruptcy Code—the preference provision—originated in the House of Representatives. See H.R. 8200, 95th Cong., 1st Sess. § 547 (1977).

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[13] Accordingly, this case does not present the question of how (or whether) the IRS must trace trust fund taxes when it seizes an employer's assets. See, *e.g.*, *United States* v. *Daniel (In re R & T Roofing Structures & Commercial Framing, Inc.)*, 887 F.2d 981 (9th Cir. 1989).

The House Committee on the Judiciary's Report accompanying H.R. 8200 has been viewed by this Court as authoritative evidence of Congress's intent. See, *e.g.*, *Northwest Bank Worthington* v. *Ahlers*, 485 U.S. 197, 208 (1988) (relying on House Report's definition of "property"); *United Savings Ass'n* v. *Timbers of Inwood Forest Associates*, 484 U.S. 365, 372 (1988); *Ohio* v. *Kovacs*, 469 U.S. 274, 279 (1985). And the House Report pertaining to Section 547 specifically addressed the pre-petition payment of trust fund taxes.[14] It stated:

> A payment of withholding taxes constitutes a payment of money held in trust under Internal Revenue Code § 7501(a), and thus *will not be a preference* because the beneficiary of the trust, the taxing authority, is in a separate class with respect to those taxes, if they have been properly held for payment, as they will have been if the debtor is able to make the payments.

H.R. Rep. No. 595, *supra*, at 373 (emphasis added).

The thrust of what Congress intended "comes across without static: if the debtor is able to make the payment, the taxes 'have been properly held for payment,'" and thus such trust fund payments may not

[14] Petitioner errs in claiming (Br. 12-17) that the House Committee Report refers to statutory language that was not enacted. No court that has addressed the issue, including the District of Columbia Circuit in *Drabkin*, has reached petitioner's surprising conclusion. In fact, the House version of Section 547(b), which is discussed in H.R. Rep. No. 595, was ultimately enacted. Compare H.R. 8200, 95th Cong., 1st Sess. § 547 (1977). The much broader Senate version of Section 547, which excluded from preference treatment *all* pre-petition tax payments and not simply trust fund payments, was not passed. See 124 Cong. Rec. 32,400 (1978) (statement of Rep. Edwards); *id.* at 34,000 (statement of Sen. DeConcini).

be reached as preferences under Section 547. *Drabkin* v. *District of Columbia*, 824 F.2d at 1118 (R.B. Ginsburg, J., dissenting). See also Pet. App. A18; *Pereira* v. *United States (In re Rodriguez)*, 50 Bankr. 576, 581 (Bankr. E.D. N.Y. 1985) ("the House Report on § 547(b) recognized that where the debtor was able to make the withholding tax payments as evidenced by his delivery of the funds to the IRS, the monies should be labeled trust funds and the debtor's duty as trustee regarded as completed"); *Razorback Ready-Mix Concrete Co.* v. *United States (In re Razorback Ready-Mix Concrete Co.)*, 45 Bankr. 917, 922 (Bankr. E.D. Ark. 1984) ("if the debtor was able to make the payments, designated the payments as 'taxes due' *and* delivered the payments to the government, the monies could be labeled trust funds and the debtor's duty as trustee was accomplished").

This express intent of Congress is readily understandable in light of the policies underlying Section 547 of the Bankruptcy Code and Section 7501 of the Internal Revenue Code.[15] Congress and this Court have noted that a struggling business may be tempted to fulfill its trust fund obligations only after it pays its other bills, a problem Congress sought to address with Section 7501. See, *e.g.*, H.R. Rep. No. 595, *supra*, at 193. Congress further recognized the likelihood that a business will commingle trust funds with other funds. See, *e.g.*, 124 Cong. Rec. 32,417 (1978) (statement of Rep. Edwards); *id.* at 34,017 (state-

[15] Petitioner argues (Br. 18) that, if Congress had meant to exclude pre-petition payments identified as trust fund taxes from Section 547, it would have done so explicitly. This proves too much; one could just as easily say that, had Congress meant to require strict tracing or a segregated trust account, it would have done so explicitly.

ment of Sen. DeConcini). Congress has not prohibited such commingling, but it would be illogical to think that Congress intended the debtor's identification of trust funds to be questioned when the debtor avoids the temptation to dissipate trust fund taxes and actually pays over such amounts to the IRS. This is particularly true given that the government's collection of trust fund taxes—which were originally paid by the employee or the transportation user—does nothing to undermine the central goal of the preference provision in the Bankruptcy Code to prevent a struggling enterprise from unfairly favoring one of its creditors. See generally *Collier on Bankruptcy*, *supra*, ¶ 547.01, at 547-11 to 547-13. For these reasons, it was eminently sensible for Congress (as the House Report explicitly stated) to exclude pre-petition payments that are identified as trust fund taxes from the preference provisions of Section 547.

3. Petitioner relies heavily (Br. 13-18) on the majority opinion in *Drabkin* v. *District of Columbia*, *supra*. In that case, the majority held that certain pre-petition payments of trust fund taxes could be recovered by the bankruptcy estate because the local government could not adequately trace the taxes. For the reasons we have explained above, however, *Drabkin* was wrongly decided. The majority in *Drabkin* misread the plain meaning of the House Report on Section 547; specifically, the panel failed to distinguish between a business's trust fund obligations and a business's own tax liabilities, such as corporate income taxes.[16]

[16] The *Drabkin* majority also reasoned that the House Report's passage concerning trust fund taxes was in the wrong place to support the government's position. The majority stated that "we would expect to find the passage in its commentary on section 541, which defines what property is included in the debtor's estate." *Drabkin* v. *District of Columbia*, 824 F.2d at 1112. We disagree. It was quite natural for the House to discuss preferences in its report addressing Section 547—the section setting forth the preference provisions.

The *Drabkin* majority began by correctly noting that Congress intended that some pre-petition tax payments could be avoided as preferences. That is clear from the fact that Congress ultimately rejected the Senate proposal that would have eliminated all tax payments from the reach of Section 547. See 124 Cong. Rec. 32,417 (1978) (statement of Rep. Edwards); *id.* at 34,016 (statement of Sen. DeConcini). What the *Drabkin* majority failed to recognize, however, was that Congress consistently distinguished between taxes collected or withheld by the debtor (*i.e.*, taxes held in trust for the government) and taxes incurred by the debtor itself. See, *e.g.*, 124 Cong. Rec. 33,999-34,000 (1978) (statement of Sen. DeConcini); H.R. Rep. 595, *supra*, at 191-192; S. Rep. 989, *supra*, at 14; S. Rep. No. 1106, *supra*, at 33. Thus, the *Drabkin* majority is correct in its view that the House Report on Section 547(b) (H.R. Rep. No. 595, *supra*, at 373) shows that *some* tax payments might be avoidable preferences. But the notion that some pre-petition tax payments may be subject to avoidance as preferences does not support the conclusion that the payments of *trust fund* taxes may be avoided.

Accordingly, as the court of appeals recognized in this case (Pet. App. A18), non-trust fund taxes, such as corporate income taxes, Federal Unemployment Tax Act taxes, and the employer's share of FICA taxes, may be recovered by the bankruptcy estate under Section 547(b). By contrast, pre-petition payments of trust fund taxes are not transfers of the debtor's property that can be recovered

as preferences under Section 547. This is the view stated in the House Report (p. 26, *supra*); and, as we have explained, that view fully comports with the text of all pertinent statutory provisions and with the logic of Congress's undertaking in the Bankruptcy Code to limit the effect of this Court's decision in *Randall.*

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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